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Recommendations for the guidance of contractors for the reporting of actual and direct exploration expenditure

Issued by the Legal and Technical Commission

The Legal and Technical Commission, acting pursuant to regulation 39 of the Regulations on Prospecting and Exploration for Polymetallic Nodules in the Area, regulation 41 of the Regulations on Prospecting and Exploration for Polymetallic Sulphides in the Area and regulation 41 of the Regulations on Prospecting and Exploration for Cobalt-rich Ferromanganese Crusts in the Area, issues the following recommendations for the guidance of contractors.

I. Introduction

1. In the present recommendations for guidance, references to "the Regulations" are collective references to the Regulations on Prospecting and Exploration for Polymetallic Nodules in the Area, the Regulations on Prospecting and Exploration for Polymetallic Sulphides in the Area and the Regulations on Prospecting and Exploration for Cobalt-rich Ferromanganese Crusts in the Area. References to "the standard clauses" are references to the standard clauses applicable to the particular contract in question.

2. The purpose of the present recommendations is to provide guidance to contractors in relation to the following matters:

(a) The books, accounts and financial records to be maintained in accordance with section 9 of annex 4 to the Regulations;

(b) The identification of internationally accepted accounting principles;

(c) The presentation of financial information in the annual reports to be submitted pursuant to section 10 of annex 4 to the Regulations;

(d) The definition of the actual and direct costs of exploration, as set out in section 10.2 (c) of annex 4 to the Regulations;

(e) The form of certification of actual and direct exploration expenditure.

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3. Except otherwise stated, words and phrases defined in the Regulations have the same meaning in the present recommendations for guidance.

4. The purpose of requiring detailed financial reports to be submitted is twofold. First, it is a due diligence requirement that is commonly found in exploration and mining contracts and is included as a means for objective quantification of the contractors' compliance with its plan of work. In this regard, as part of the process of application for a plan of work for exploration, contractors are required to provide a five-year programme of activities and a schedule of anticipated annual expenditure in respect of such programme. Under the standard clauses (annex 4, sect. 4.2), contractors are required to spend in each contract year not less than the amount specified in the programme of activities, or any agreed review thereof, in actual and direct exploration expenditure. The annual financial report is thus the only means by which the Authority is able to verify objectively the contractors' compliance with these provisions.

5. The second reason for requiring financial reports is potentially of direct benefit to the contractor. It is a general practice in the mining industry to allow some element of the costs of developing a mine site to be set off against the eventual income from production. As far as seabed mining is concerned, detailed provisions relating to the definition of "development costs" and their recovery in certain circumstances were included in article 13 of annex III to the United Nations Convention on the Law of the Sea. By reason of the Agreement relating to the Implementation of Part XI of the Convention, these provisions no longer apply. Nevertheless, the possibility that the Authority may in due course make provision for the recovery of some element of development costs is foreseen in annex 4, section 10.2 (c), of the Regulations, which provides that such expenditure may be claimed by the contractor as a part of the contractor's development costs incurred prior to the commencement of commercial production. In these circumstances, it is particularly important that there be some means of verifying objectively the amount of such expenditure, its relationship to the programme of activities and whether it is actual and direct exploration expenditure.

II. Books, accounts and financial records

6. Section 9 of annex 4 to the Regulations requires each contractor to keep a "complete and proper set of books, accounts and financial records, consistent with internationally accepted accounting principles". For the purposes of the Regulations, the Commission recommends that contractors adopt and apply the International Financial Reporting Standards adopted by the International Accounting Standards Board, in particular Standard 6, relating to the financial reporting of expenditure associated with the exploration for and evaluation of mineral resources. Furthermore, in order to ensure comparability with the contractor's financial statements of previous years, as well as with the financial statements of other contractors, all financial statements, including the financial statement to be included in the annual report required under section 10 of annex 4 to the Regulations, should be provided in a format consistent with International Accounting Standard 1.

III. Presentation of financial information

7. Section 9 of annex 4 to the Regulations also stipulates that "such books, accounts and financial records shall include information which will fully disclose the actual and direct expenditures for exploration and such other information as will facilitate an effective audit of such expenditures". Accordingly, the information to be disclosed by contractors should make it possible to identify and explain the reported amounts in the financial statements arising from the exploration and evaluation of mineral resources. To this end, it is recommended that contractors indicate their accounting policies for exploration and evaluation expenditure, including the recognition of exploration and evaluation assets. Contractors should also disclose the amounts of assets, liabilities, income and expense, and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

8. Financial statements should cover the same period as the reporting period and should normally correspond to a calendar year. Where this is not possible, for example because the country in which the contractor is based has a different financial year, the contractor should indicate the accounting year and, as far as possible, should provide a prorated summary of expenditure matching the reporting year.

9. The financial statement should be consistent with the proposed programme of activities, including the proposed schedule of annual expenditure, contained in schedule 2 of the contract over the equivalent period of time. Any deviation from the proposed programme of activities or schedule of annual expenditure should be clearly reported and explained. This should also be in accordance with a formal adjustment to the proposed programme, which would have been agreed on by the parties.

10. When an exploration activity continues beyond an accounting year, the reported costs should relate only to activities that were carried out during the relevant accounting year. Such expenditure should be clearly distinguished from the costs that are associated with past, previous or future exploration activities.

11. Where expenditure is nil, this should also be stated.

IV. Actual and direct exploration expenditure

12. In accordance with the Regulations, reported expenditure should relate only to the actual and direct costs of exploration. Not all expenditure incurred during a reporting period may be considered as an actual and direct cost of exploration. In general, actual and direct exploration costs are considered to be those that were necessary for carrying out exploration activities for the particular resource covered by the contract within the financial period in question and in accordance with the programme of activities set out in the contract for exploration. Such costs should be properly itemized in the breakdown of expenditure.

13. Pursuant to regulation 1.3 (b) of the Regulations, "exploration" means the search for deposits in the Area with exclusive rights, their analysis, the use and testing of recovery systems and equipment, processing facilities and transportation systems, and the carrying out of studies of the environmental, technical, economic,

commercial and other appropriate factors that must be taken into account in exploitation. Consequently, it may be considered that the costs associated with exploration must be those that fall under the list of activities defining the term "exploration". International Financial Reporting Standard 6 also provides a non-exhaustive list of examples of expenditure that might be presented in the initial measurement of exploration and evaluation assets. To be considered as direct, expenditure must have been incurred directly in connection with the exploration work that has been undertaken in accordance with the programme of work in the contract. A recommended format for the statement of actual and direct exploration expenditure is contained in the annex.

14. Reported expenditure also needs to relate to actual costs. This means that the costs have actually been incurred and are not notional, estimated or projected. Actual costs are also associated in time with those that occurred during the reporting year. Therefore, they exclude those that relate to past or future exploration work. Actual costs may be different from projected costs, but grounds for any variation should be provided in the report.

V. Certification of financial statements

15. It is a requirement of the standard clauses for exploration contracts that the financial statements showing the actual and direct exploration expenditure of the contractor in carrying out the programme of activities during the accounting year be certified by a duly qualified firm of public accountants or, where the contractor is a State or a state enterprise, by the sponsoring State.

16. In order to avoid confusion in the application of these requirements, where the contractor is a State or State-owned enterprise, the contractor should indicate in the annual report which entity of the sponsoring State is entitled to certify the financial statements.

17. The date of receipt of the certification should be the same as for other elements of the annual reports, that is, no later than 31 March of each year. Where this is not possible, for example where the certifying authority applies a different financial reporting period, the contractor should indicate the tentative date of submission in the annual report. Once the certificate is available, the contractor should transmit it to the Secretary-General without delay.

Annex

Recommended format for the statement of actual and direct exploration expenditure

1. Expenditure should be reported against the following headings:

- **Exploration work**
  - Research and analysis, including field investigation
  - Equipment and instruments
- **Environmental studies**
  - Research and analysis, including field investigation
  - Equipment and instruments
- **Mining technology development**
  - Research and analysis, including field investigation
  - Equipment and instruments
- **Metallurgical process development**
  - Research and analysis, including field investigation
  - Equipment and instruments
- **Training**
- **Other activities**
  - Preparation of annual report
  - Any other actual and direct exploration expenditure not covered under the above headings, but forming part of the programme of activities under the contract

2. Where an item of expenditure may be attributed to several activities, it should be reported under one heading only, so as to avoid any duplication.

3. Reported expenditure under each heading should, as far as possible, be broken down into: (a) operational expenditure; (b) capital expenditure; (c) staffing and personnel costs; and (d) overhead costs. If a cruise was undertaken, the actual day rate for ship time and the day rate for any large item of equipment used during the cruise should be specified.

4. Capital expenditure on a single item exceeding $200,000 in any one year should be itemized in the report.